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C O N F I D E N T I A L SECTION 01 OF 03 BAGHDAD 002534

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STATE FOR COUNSELOR ZELIKOW
TREASURY FOR DEPUTY SECRETARY KIMMITT

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TAGS: [ECON](#) [EFIN](#) [EINV](#) [EPET](#) [ETRD](#) [PGOV](#) [PREL](#) [IZ](#)

SUBJECT: SCENESSETTER FOR DEPUTY TREASURY SECRETARY KIMMITT
AND STATE COUNSELOR ZELIKOW'S VISIT TO IRAQ

REF: A. BAGHDAD 2499

Classified By: Charge d'Affaires David M. Satterfield for reasons 1.4 (b) and (d).

¶1. (C) SUMMARY. Your visits to Iraq for the launch of the International Compact on July 20 provide an opportunity to fundamentally change Iraq's foreign relationships by helping it overcome the political divisions in the international community that arose prior to and during the war and have survived since. Central to the Compact will be the occasion to press the GOI for action on economic reform that would change positively the investment climate (particularly in the hydrocarbon sector), open the country to international trade, and dismantle the remnants of the country's command economy. Your visits come at a time when Deputy Prime Minister Barham Saleh and Prime Minister Nuri al-Maliki are focusing on an economic revitalization plan and have envisioned the launch of the International Compact as a means to assist in reform and reconstruction. END SUMMARY.

PUBLIC AND PRIVATE MESSAGES

¶2. (C) Your public and private messages should be supportive of the Maliki government. Publicly you should praise the government's attempts to address the essential troika of issues essential to its political and economic recovery -- reconciliation, security, and economic reform. The reform measures being considered hold the promise of hastening Iraq's economic recovery, which is essential to the political success of the Maliki government. At the same time, some features may be unpopular and potentially destabilizing to the still new and fragile government. Accordingly, a focus on the desired end state should be an emphasis. You should also acknowledge frankly the security challenges the GOI faces and emphasize the need for inter-ministerial cooperation across the board to protect infrastructure and develop an attractive foreign investment regime.

¶3. (C) However, your private message should be sharper, pressing the need for economic reform now to set the stage for job creation and create the basis for an investment inflow. You should be candid in discussing the need for price reform to curb corruption and eliminate unsustainable expenditures on subsidies. Also in regard to endemic corruption, you should take every opportunity to emphasize the need to enlist public support for anti-corruption measures and improve relevant judicial and administrative means used in the anti-corruption fight.

¶4. (C) With the Compact launch and subsequent elaboration of its work program, we anticipate that new relationships will be created between Iraq and its surrounding Gulf neighbors, as well as with states, such as France and Germany, who fell out with the U.S. over the war. We anticipate that these states will have particular interest in seeing adequate attention paid to political reconciliation and security. The GOI will need to devote attention to these issues, as they will be viewed as prerequisites for providing the economic assistance and technical advice that Iraq still desperately needs.

OVERALL STATE OF THE ECONOMY

¶5. (SBU) Iraq is starting to achieve concrete economic results, in spite of the tough security environment. The IMF decision on December 23 to approve a Stand-By Arrangement for Iraq will permit debt relief that should forgive 80 percent of a \$130 billion total debt by the end of 2007. In addition to removing this crushing burden, the SBA also has prompted subsidy reductions for fuels. Under the subsidy system, prices did not even cover the cost of production, corruption abounded, and resources were taken away from health, education infrastructure development, and security. As part of the SBA, Iraq has committed to fuel price increases so that, by the end of the 1st quarter of 2007, prices for refined products will approach (or in the case of premium gasoline) exceed prices of other Gulf states. These price increases should remove much of the incentive for smuggling across the borders.

¶6. (SBU) Many of Iraq's economic indicators are now in

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favorable territory. We believe Iraq had a GDP growth in the 3 percent range in 2005. The IMF expected that to improve to better than 10 percent this year, but it is unclear to what extent ongoing security problems will undercut growth. Iraq lacks the quantity and quality of macroeconomic numbers needed for accurate analysis of the economy, but we can see concrete evidence of increasing prosperity in new patterns of consumption and service use. Importantly, the GOI appears ready to move away from the dysfunctional centralized economy of the Saddam era.

MALIKI'S SPEECH ON ECONOMIC REFORM

¶7. (SBU) On July 12, Prime Minister Maliki spoke to the Council of Representatives (parliament) about the need for policy initiatives in the areas of security, reconciliation, and economic reform. His central focus was on the economy, however. The speech, clearly one of the most reformist offered by an Arab leader in decades, put the government on record for change in the key areas of the economy. Maliki strongly spoke out for passage of a new investment law, anti-corruption measures, an expanded social safety net for the poor, a new housing program, acceptance of foreign investment in the oil and electricity sectors, and restored financial and economic relations with Gulf states -- Saudi Arabia, in particular. Throughout Maliki's remarks, the private sector was cited as a basic engine of growth. The International Compact was also highlighted. In your meetings with officials, you will want to take advantage of the opportunity to offer our assistance to advance the PM's market-oriented ideas.

INVESTMENT LAW

¶8. (SBU) DPM Saleh is spearheading the GOI's efforts to pass a new investment law. It is intended to supersede the

never-implemented CPA law 39 and has some basis in Jordan's current investment law. Embassy Baghdad provided suggestions to Saleh in the early drafting stages and was encouraged that many of these suggestions were incorporated in the revised text that went to the Economic Affairs Committee and Council of Ministers in June. As a result of further consultations, a few additional revisions were made that appear to further improve the law (ref A). Suggestions incorporated included reducing the number of regulatory committees in the original draft and including provisions for international arbitration.

Among negative features, it still does not permit foreign ownership of natural resources or land; 50-year renewable leases are permitted. Although a step forward, the draft will not establish a truly competitive investment regime, something we have told Saleh. You may wish to reinforce the argument that an open investment regime will be needed to compete effectively for foreign investment and that the government should prepare itself to fight against watering down of the legislation in the CoR.

NATIONAL ENERGY STRATEGY

¶9. (SBU) Iraq needs a new energy strategy. Fuel import liberalization legislation currently is pending approval by the Council of Representatives after recent approval by the Council of Ministers. This is an important first step in opening the sector to private enterprise, undermining the black market, and improving fuel supply. In addition, resolving significant center-regional issues by clarifying the division of authority over resource management and revenue distribution is necessary groundwork for effective hydrocarbon legislation. A key element of a hydrocarbon law (or series of laws) would be a measure to attract the foreign direct investment (FDI) required for expansion in oil and gas production. Although the structure and regulation of the hydrocarbon sector will be a critical aspect of national energy policy, the fact that oil export revenues account for upwards of 95 percent of the state budget -- and while Iraq is at war should be taken carefully into account.

LOW LEVEL OF ECONOMIC UNDERSTANDING

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¶10. (SBU) Key decision-makers in the Council of Representatives are largely under-educated on economic issues. This is the product of the isolation of Saddam's regime, its orientation towards socialist states of the former Soviet bloc, and the prevalence of a culture of dependency. We have begun to educate key members and backbenchers of the Council of Representatives on sound energy policy, subsidy reform, and the need for public integrity, and transparency in the oil and gas sectors. In addition, an expanded GOI public outreach campaign is needed to educate Iraqis on the need to fight corruption and to continue subsidy reductions. Embassy is partnering with the Iraqis to create TV spots on economic reform issues and to build public affairs capacity within the various ministries, the Council of Representatives, and the Government Communications Directorate (The GOI's public affairs arm).

COMMENT

¶11. (SBU) The government of PM al-Maliki is still less than two months old, so it is too soon to advance more than a preliminary judgment on its ability to make economic policy. Nevertheless, even in this brief period, we have seen a flurry of activity that surpasses the actions taken by the al-Jafari government over the course of an entire year. Much of the credit appears due to DPM Barham Saleh. He chairs the

recently formed Economic Affairs Committee and has had charge of all preparations on the Iraqi side for the Compact. With successes (so far) in pushing fuel import liberalization through to the parliament and in also securing approval of the Council of Ministers for a new investment law, he seems to have demonstrated significant political influence. We had been told by several sources that he had been regarded as the "Kurdish" DPM, kept by PM Maliki in a familiar political balancing act. However, watching him maneuver around the Compact, collaborating with the U.S., UK, UN, etc. in succession - one is struck by his energy level and natural political ability. And at least so far, PM Maliki seems ready to extend his support.

CONCLUSION

¶12. (SBU) Your trips are very significant. In addition to raising policy issues that will help to increase foreign trade and investment opportunities, your visits have an important public outreach dimension. The new government has made a brave start, but its confidence has been shaken by the continuing security situation. However, it will have to step up to the commitments that need to be made as part of the International Compact.

¶13. (SBU) You should compliment the GOI for its first steps to create a more liberal investment regime and to fight corruption. The latter problem is endemic and is, along with the more general problem of weak governance, the most significant problem holding back foreign investment. In your private comments, therefore, you should stress the need for rapid action on economic reform and anti-corruption. Moreover, there are legislative projects currently underway regarding fuel import liberalization, investment, and housing that all can be encouraged. Nevertheless, your most fundamental argument should be that Iraq must create the conditions to attract investment in a very competitive environment.

SATTERFIELD